

Income Transfers, Taxes, and the Poor

While government income transfer programs reduced or eliminated poverty for some benefit recipients, 10 percent of the U.S. population remained in poverty after all transfers were made in 1983. In non-metro America, the 1983 poverty rate was 12.8 percent. Moreover, many of these poor were working poor, and taxes reduced their earnings. The nonmetro working poor will benefit from recent tax reform that lessens their tax burden.

Most people are aware that the poor often receive public assistance (welfare) from the government. But other Federal, State, and local government income transfer programs (like Social Security and unemployment insurance) also affect the well-being of the poor and may actually have a bigger impact on poverty than welfare.

But while government income transfers can help many poor people increase their incomes, taxes on a poor person's earnings can amount to a significant portion of income. The tax bite has tended to be bigger for the nonmetro poor, who are more likely to rely on earnings and consequently to pay taxes than the metro poor. The tax reform law passed last year will reduce the tax burden on the working poor. In this article, I examine the effects of income transfers and taxes on the measurement of poverty in America and the overall effects of these transfers and taxes on the income of the poor living in nonmetro areas.

Income Transfer Programs Help Provide a Minimal Standard of Living

Most income transfer programs are intended to protect workers and their

dependents against lost earnings by the retirement, death, or disability of a breadwinner or by temporary unemployment. Others are designed to protect people against unpredictable expenditures like medical care or to provide essentials like adequate housing and food.

Three types of programs make up today's U.S. income transfer system: cash social insurance, cash public assistance, and in-kind programs. Cash social insurance pro-

grams include Social Security, unemployment insurance, government employees' pensions, and veterans' pensions and compensation. These programs are not targeted specifically at the low-income population, but at the general population or particular groups of workers. Benefit levels are based partly on work history.

The second set of programs, called cash public assistance, includes Aid to Families with Dependent Children (AFDC), Supplemental Security Income, and general assistance. These programs are targeted to the low-income population and do not require work experience to be eligible for benefits. To obtain benefits, one must have income and assets below specified levels. And the benefits are usually reduced or withdrawn when the person gets a job or earns more money.

The final group, in-kind transfers, is tied to a specific need for a good or service.



USDA photo

Food stamps are one of the most significant transfer payments for the poor. Though such benefits are not taxed, inflation has caused the working poor to pay higher taxes.

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These benefits are in-kind in that the actual good or service is directly provided or obtained with a voucher for that good or service. They include health care benefits through Medicare and Medicaid, food benefits from the Food Stamp and National School Lunch programs, and housing benefits from public or subsidized rental housing programs. Except for Medicare and a portion of the school lunch benefits, the in-kind transfer programs are also targeted to the low-income population.

Poor persons can receive benefits from all three types of transfer programs, so that a program can help alleviate poverty even if it is directed toward the general population rather than just the poor. The best example of a program directed toward the general population which helps alleviate or prevent poverty is Social Security; it is also the Nation's single largest transfer program.

In-Kind Transfers Are Fastest Growing

The real value of total income transfers increased substantially from 1969-84. For example, the market value (the purchase price of the good or service) of cash social insurance transfers was about \$125 billion (in 1984 constant dollars) in 1969, compared with a market value of \$271 billion in 1984. Social Security benefits provided much of this increase. The market value of Social Security benefits was \$74 billion in 1969, compared with \$173 billion in 1984.

Cash public assistance transfers, while growing from a market value of \$18 billion (in 1984 constant dollars) in 1969 to \$27 billion in 1984, have declined in value since their peak in the late seventies. Aid to the poor has become concentrated in such in-kind programs as food and health care, which are directed to specific needs of the poor.

In-kind transfers are the fastest growing component of the income transfer system. The national Food Stamp program, for example, provided a market value of \$7 billion of food in 1974, its first year, compared with almost \$11 billion in 1984. The in-kind Medicaid program, begun in 1965, expanded rapidly as the

number of recipients increased and as medical costs soared. By 1984, the Medicaid program provided over \$34 billion in medical assistance. Likewise, the real value of Medicare benefits expanded from \$19 billion in 1970 to \$65 billion in 1984.

Transfers Significantly Reduce Poverty

To determine the effects of transfers on poverty, we need to determine the incidence of poverty before including government transfers as income. Pretransfer income considers only income from earnings, property income (dividends, interest, and rent), and private transfers, like pensions and alimony.

The pretransfer incidence of poverty increased from 18 percent in 1969 to 24 percent in 1983 (fig. 1), but when cash social insurance payments like Social Security, government retirement, and unemployment insurance are added to income the incidence of poverty in 1983 diminished to about 16 percent.

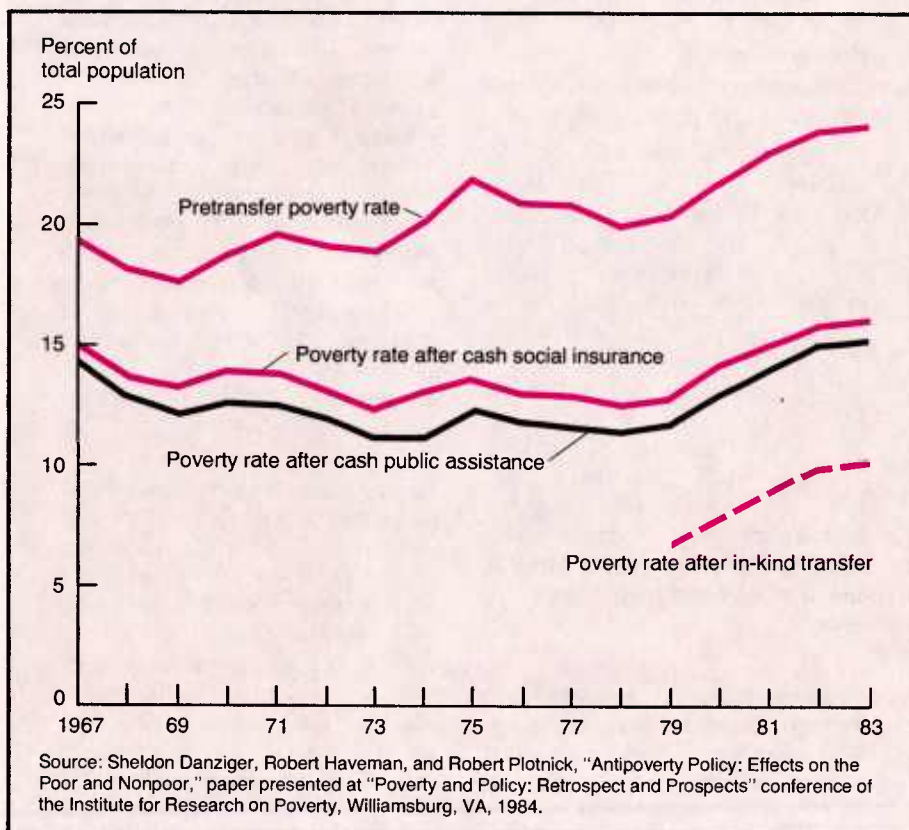
When cash public assistance payments, like Aid to Families with Dependent Children and general assistance, are also added to income, the poverty rate drops to just over 15 percent.

The government computes the official poverty rate by estimating the number of persons whose money income (including wages and salaries, self-employment income, cash government transfers, property income, and private transfers) is below a certain threshold, which depends on family size and composition. In 1983, the official poverty thresholds ranged from \$4,775 for a single person over 65 years of age to \$20,310 for a family of nine or more. The threshold for a family of four was \$10,178.

In 1983, the official U.S. poverty rate was 15.2 percent. When poverty rates for nonmetro and metro residents are computed separately, however, the 1983 nonmetro poverty rate was 18.3 percent, compared to a metro poverty rate of 13.8 percent.

The official poverty definition excludes in-kind benefits, and consequently calcula-

Figure 1
U.S. poverty rates 1969-1983



tions using this definition understate income and thus overstate the estimates of poverty. Although government outlays for in-kind benefits grew rapidly in the 1970's, the official poverty rate did not change much. If in-kind benefits were valued at the purchase price of the good or service and included as income, the national poverty rate would have dropped to about 10 percent in 1983.

Even after we account for all income transfers, the poverty rate remains higher in nonmetro areas than in metro areas. In 1983, after including in-kind transfers as income, the nonmetro poverty rate was 12.8 percent, compared with the 9.1-percent metro rate. Differences in program participation rates partially explain the higher nonmetro poverty rate, since the nonmetro poor are less likely to participate in in-kind programs, particularly housing and Medicaid programs.

Income transfers have been less effective at reducing poverty recently. They have removed a smaller proportion of the pretransfer poor from poverty, and post-transfer poverty rates have risen since

1978. In particular, the effectiveness of cash public assistance transfers was reduced by the Omnibus Budget Reconciliation Act of 1981, which modified the AFDC program by targeting benefits to the "truly needy," or those unable to work. Because AFDC income eligibility limits were lowered and certain allowable deductions from income, such as child care and work expenses, were eliminated, many working poor were removed from the program in 1983.

Taxes Another Problem for Working Poor

The official poverty definition is based on after-tax income, but poverty estimates over the years have been computed from before-tax income data. Because the low-income population originally paid only a small proportion of its income in taxes, the difference between before- and after-tax income was not significant. But inflation and changes in the tax system have made the tax bite on the poor bigger, so that a family may have a before-tax income above the poverty threshold, but an after-

tax income below it. Based on before-tax income, the official poverty statistics fail to account for such families.

The two major Federal taxes affecting individuals are the income tax and the payroll tax (largely Social Security). Federal tax policy is particularly important in nonmetro areas, where most poor families contain a worker whose earnings are subject to the payroll tax. In 1983, over 68 percent of nonmetro poor households had at least one worker, and 29 percent had two or more. In contrast, only 54 percent of metro poor households had at least one worker, and only 15 percent had two or more.

During the early 1970's, Federal income tax liability for poor families was kept to a minimum by various laws that increased the income level at which a family began to pay income tax. The earned income tax credit, enacted in 1975, provided relief from payroll tax for low-income taxpayers with children and improved work incentives by enabling them to keep more of the money they earned.

High inflation rates during the late 1970's raised the poverty thresholds (updated annually in step with the Consumer Price Index), but tax adjustments offsetting the effects of inflation did not keep pace.

In 1978, for example, a family of four with earnings at the poverty line paid \$269 in Federal income tax and Social Security tax. By 1984, that same family paid \$1,075 in Federal income and payroll taxes, an increase of \$800. Expressed as a percentage of income, Federal income and payroll taxes consumed 10.1 percent of the earnings of a four-person family at the poverty level in 1984, compared with 4 percent in 1978. Add on State, property, and sales taxes, and taxes can consume an important part of a poor family's income.

In 1983, nonmetro poor households were more likely to pay Social Security taxes and Federal income taxes than were metro poor households (fig. 2). These figures reflect the higher proportion of nonmetro households relying on earned and taxable income.

The nonmetro poor were also more likely to pay State income taxes than were the

Transfer Payments Are Important to Regional Economies

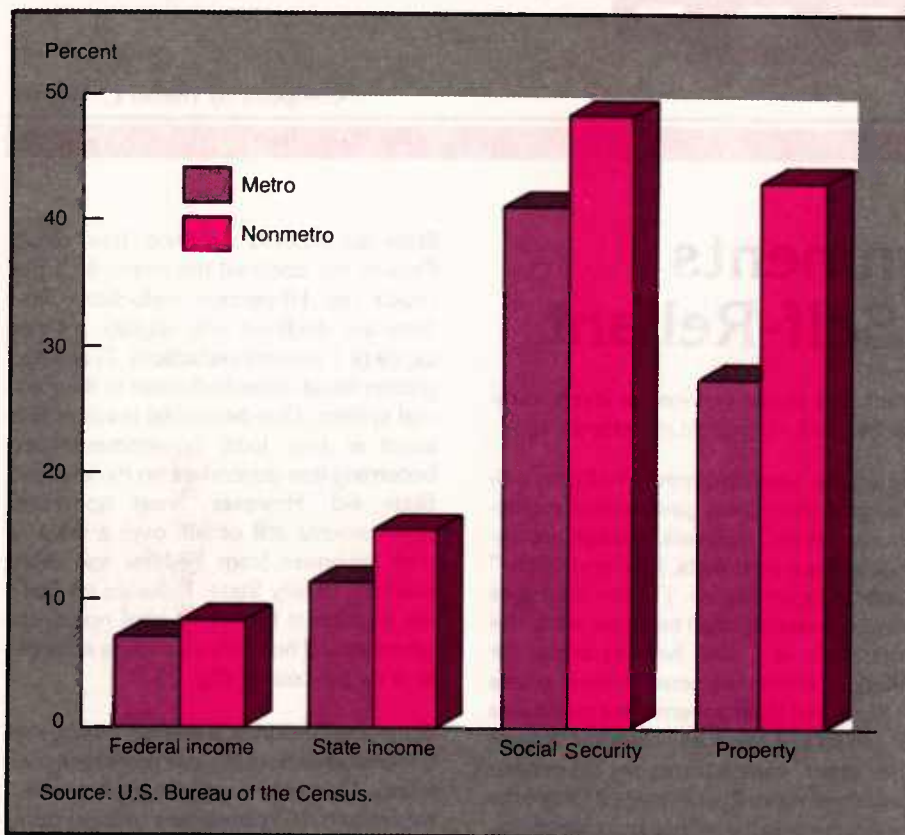
Income transfers are a major source of personal income not only to recipients, but to the regions where they live. Income received as transfer payments in 1984 equaled \$416 billion, or 13.8 percent of all personal income nationwide, according to the U.S. Department of Commerce's Bureau of Economic Analysis (which defines transfer payments to include some in-kind programs like Food Stamps and Medicare, but excludes others like Medicaid, school lunches, and public housing.) In nonmetro America, personal income received as transfer payments totaled \$96.8 billion, or 17.2 percent of all personal income.

Social Security is the largest transfer payment program, accounting for 45.4 percent of all transfer payment income in nonmetro America in

1984. Medicare is next, accounting for 14.7 percent of transfer payment income. The remaining payments were from military retirement (7.1 percent), State and local government retirement (4.3 percent), Federal retirement (4.2 percent), unemployment compensation (4.1 percent), Food Stamps (3.1 percent), Supplemental Security Insurance (2.8 percent), Aid to Families with Dependent Children (2.4 percent), railroad retirement (1.8 percent), general assistance (0.2 percent), and miscellaneous other programs (9.9 percent).

Metro counties had somewhat higher per capita benefits (\$1,774) than nonmetro counties (\$1,734), but transfer payments in metro counties accounted for a smaller portion of total personal income, about 13.8 percent. Transfer payments are especially important in the nonmetro Northeast and the nonmetro South, where they accounted for almost 20 percent of personal income in 1983.

Figure 2
U.S. households in poverty, percent paying taxes, 1983



metro poor, and, since the nonmetro poor are more likely to own their own homes, they were more likely to pay property taxes.

Many people whose before-tax income is just over the poverty line pay enough income and payroll taxes to place their after-tax, or spendable, incomes below the poverty threshold. If the 3 million taxpayers whose after-tax incomes were below the poverty threshold in 1983 were counted as poor, the national poverty rate would have been 16.5 percent.

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Constructing poverty rates using different measures of income, such as pretransfer income or income after taxes, helps us to evaluate the impact of transfers and taxes on poverty. Cash social insurance transfers are the most effective types of transfers in alleviating poverty, followed by in-kind transfers and cash public assistance. In recent years however, the post-transfer poverty rate has grown more rapidly than the pretransfer poverty rate, indicating that these income transfers have become less effective in reducing poverty.

Poverty has proved difficult to eliminate, although we spend billions of dollars annually on income transfers. Recent public debate on the government role in reducing poverty has centered on three components of income security policy: minimum income guarantees, work incentives, and program costs. A minimum income guarantee would provide a basic income floor for the poor. However, a basic minimum income program would also need to incorporate work incentives for those able to work. A program which would provide both basic needs and preserve work incentives may be very costly, as well as difficult to formulate. In the meantime, however, recent Federal tax reform will enable the working poor to retain more of their earnings.

Any major changes in income security policy are likely to have somewhat different effects in metro and nonmetro areas.

Minimum income guarantees would be particularly important in nonmetro areas, for many nonmetro poor who receive transfers are still in poverty. Cash public assistance benefits, primarily Aid to Fami-

lies with Dependent Children, are lower in nonmetro than metro areas. A national minimum AFDC benefit level, for example, is likely to be higher than the benefit received by many rural residents, and this would increase the effectiveness of that program in nonmetro areas.

Work incentives and the targeting of public assistance to the truly needy, or those unable to work, are also important issues in nonmetro areas. Many nonmetro poor households already contain at least one worker and are not able to escape poverty through working. These families may need further assistance. Recent Federal tax reform will alleviate part of the problem by raising the income levels at which families begin to pay taxes on their earnings and improving the after-tax incomes of the many working poor and near-poor. Similar reforms in State income tax laws would also help many working poor.

Income transfers are only part of the income story for many poor. For example, in the last several years, as Federal income transfer policy has sought to increase work incentives for the able-bodied poor, Federal income taxes have had the opposite effect. As changes in income transfer policy are proposed and debated, an examination of all facets of government policies is necessary to ensure that they work in concert in the fight against poverty.

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For Additional Reading...

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